

always reflect the lowest cost of an optimal network. Like an ILEC, a competitor would not be able to replace its network with each new technology advance. Thus, by using LEC network elements and facilities, a competitor avoids all risk and achieves a result it could never achieve if it built its own network. Equally perverse, is that such hypothetical pricing would shift all investment risk to the ILEC.

There is substantial agreement that a primary objective of the Act is to encourage facilities based competition in the local exchange.⁶⁷ A pricing standard based on hypothetical, optimal network costs which would create disincentives for new entrants to invest in their own local facilities can hardly be viewed as consistent with the Act's requirements.

3. Proxies Have Limited Usefulness

The inquiry in the Notice regarding the use of proxies was viewed by some commenters as an open invitation to substitute hypothetical cost models, such as the Hatfield model, as a means of establishing the costs and setting the prices for interconnection and unbundled network elements.⁶⁸ As discussed above, the Act's requirements could not be satisfied by a regulatory mandated requirement that a hypothetical cost be used to set prices.⁶⁹

The role proxies can legitimately play within the framework of the Act is as a measure of the upper range of reasonableness of prices. As BellSouth presented in its Comments, there are certain natural parameters that can be used to identify the upper bound of reasonable rates for

⁶⁷ Time Warner at 3, MFS at 3-4.

⁶⁸ AT&T at 51-54, MCI at 68.

⁶⁹ Given the extraordinary short period to analyze submissions accompanying the Comments, it was not possible to perform a complete review of the Hatfield model. Nevertheless, the model has several obvious deficiencies and there are numerous outstanding questions. These deficiencies and questions are identified in an analysis, "Comments on Hatfield Study" prepared by Strategic Policy Research and provided as Attachment I.

interconnection and unbundled elements.⁷⁰ The first is a market price for elements that are available from sources other than the ILEC.⁷¹ If there is no market price for the element but there is an access analog, then the access price would be the ceiling.⁷² Finally, if neither a market price nor an analogous access service were available as an upper bound measure, then stand alone costs would define the upper range of reasonable prices

C. Transport and Termination--The Commission Cannot Mandate Bill-and-Keep, Even On An Interim Basis

Many parties urge the Commission to impose bill-and-keep for the purposes of establishing reciprocal compensation under the Act.⁷³ These parties are undaunted by the plain language of the Act which requires that mutual compensation be based on each carrier's costs to transport and terminate interconnected traffic. They mistakenly believe that the Commission can bootstrap such a requirement based on the provision in Section 252 that the Section of the Act shall not preclude arrangements that waive mutual recovery such as bill-and-keep.⁷⁴

Section 252(d)(2) instructs state commissions that they may not consider the terms and conditions of a reciprocal compensation arrangement unjust and unreasonable if such arrangement includes a waiver of mutual recovery such as bill-and-keep. Without a doubt, the right to waive

⁷⁰ BellSouth at 55-56.

⁷¹ Such prices are effectively capped by the market and reflect a competitive market cost constraint.

⁷² There can be no question that access prices fall within the just and reasonable range. The Commission's price cap rules insure such results. In this circumstance, the access price also represents the maximum price for an analogous unbundled element or for interconnection.

⁷³ Sprint at 87, TCI at 26, Time Warner at 92, Cox at 27-28, TCI at 26.

⁷⁴ § 252(d)(2)(B)(i)

mutual recovery of costs is vested in the parties to the arrangement. There is nothing in the Act that authorizes a state commission, let alone this Commission, to mandate bill-and-keep.

Nor should it be particularly surprising that the Act permits bill-and-keep arrangements only when they are established through arrangements voluntarily agreed to by the parties. An attempt by any commission to mandate bill-and-keep arrangements would constitute a taking without just compensation in violation of the Takings Clause of the Fifth Amendment of the Constitution.⁷⁵

The legal infirmities associated with mandatory bill-and-keep are not overcome merely by characterizing the arrangement as interim. If the object is to reach some simple, cost-based approach for arriving at transport and termination charges, then the solution is to allow parties to negotiate. Each attempt by the Commission to create rules that displace negotiations as the primary means of reaching agreement will more than likely have the unintended consequence of complicating and slowing the implementation of the Act.⁷⁶

D. Resale

⁷⁵ Those who would argue that the Commission should adopt regulations, such as mandatory bill-and-keep, ignore the Court's admonition that "[w]ithin the bounds of fair interpretation, statutes will be construed to defeat administrative orders that raise substantial constitutional questions." Bell Atlantic Tel. Cos. v. FCC, 24 F. 3d 1441, 1445 (D.C. Cir. 1994). Nowhere in the Act was any commission given a broad authority to take property. Accordingly, if the Commission were to adopt the extreme position of some parties and mandate bill-and-keep and thereby create the constitutional conflict, such regulations would be invalid under existing legal precedent.

⁷⁶ Perhaps it is this consequence that underlies the position of some parties that the Commission create detailed federal rules and requirements. The advantage these parties would realize by slowing the implementation of the Act is self-evident. These parties will be entering the local market regardless of whether the Commission adopts rules or such rules are being contested. If these parties, however, can succeed in getting the Commission to adopt rules of questionable validity, they believe that the confusion and litigation will delay the Commission's approval of BOC entry into the in-region interLATA market

Under the provisions of Section 252(d)(3) of the Act, wholesale rates shall be based on retail rates less avoided costs. In keeping with their call for the Commission to prescribe rules that cover each and every element of the Act, some parties claim that the Commission should identify specific expense categories (based on the Uniform System of Accounts (USOA)) that should be used to determine avoided costs.⁷⁷

The Commission is in no position to identify avoided costs by specifying USOA expense accounts. Each expense category set forth in the USOA contains many different kinds of expenses. The categories are intended to represent broad groupings of expenses, not specific cost elements. Specification of USOA accounts would do little to identify specific expense items that would be included in a determination of avoided costs. Moreover, because the USOA categories are broad, there is some discretion regarding the particular USOA category to which a specific expense item is recorded. Thus, no single list of accounts would be applicable to all LECs.

The determination of avoided costs is an area where Commission rules are neither necessary nor are they called for by the Act. The Act confers upon the state commission the responsibility of determining avoided costs. It would be a clear conflict with the plain language of the Act that gives state commissions the authority if the Commission attempted to limit avoided costs to a list of specified USOA categories.

Sprint suggests the Commission adopt an imputation rule that would limit the price of unbundled elements (in aggregate) whose functionalities could be combined to form the

⁷⁷ COMPTTEL at 96-97; AT&T at 84; MCI at 91.

equivalent of a retail service to the retail price⁷⁸ Such a rule is without any logical basis and would be contrary to the requirements of the Act.

There is absolutely no basis to conclude that there must be a relationship between the prices of unbundled elements and wholesale prices based on retail rates. The retail rates reflect a myriad of ratemaking factors that fall under the exclusive purview of state commissions. In some instances, retail rates reflect social pricing policies the state commissions have followed which in their expert opinions promote the public interest. The Act, nonetheless, requires that such retail rates be the basis of the wholesale rates for resold services. In contrast prices for unbundled elements are required by the statute to be based on costs.⁷⁹ The Commission is not free to disregard the Act's requirements and cap the prices of unbundled elements as Sprint's imputation rule would do.⁸⁰

The Act's requirements notwithstanding, there is no reason to assume that prices of unbundled elements would sum to retail rates. The fallacy of the imputation rule is the assumption that the whole can be dismantled into parts at the same cost. This is simply not the case. No one would argue that purchasing all of the parts of an automobile and then assembling them, while technically possible, would be less expensive than purchasing an assembled car. If

⁷⁸ Sprint at 72.

⁷⁹ The different treatment under the Act of unbundled elements, on the one hand, and resale, on the other, supports the notion that unbundled elements should not be permitted to be used as a substitute for resold retail services. The purpose of requiring incumbent LECs to provide unbundled elements is to provide competitors with functions and facilities to fill out their own networks. Nothing in the Act contemplates that unbundled elements could be used to arbitrage and avoid the Act's resale provisions.

⁸⁰ Congress provided for the distinct pricing standards for unbundled elements and wholesale rates without evidencing any expectation or requirement that they would yield charges that would bear a particular relationship

nothing else, transaction costs are increased. The imputation rule is artificial and as such it is contrary to the overall purpose of the Act of introducing facilities based competition.

AT&T argues that the Act does not contemplate offsets for costs incurred in providing resold services.⁸¹ AT&T is wrong. The Act provides that resold services will be provided at wholesale rates that are based on retail rates less avoided costs. The resale activity, itself, however, will give rise to new costs such as service order costs. In the first instance nothing in the Act precludes the establishment of distinct nonrecurring charges to compensate a LEC for establishing accounts and completing other activities that enable resale. Such charges would not violate the Act's requirement that the charge for the resold service, i.e., the wholesale rate be established at the retail rate less avoided cost. Netting would simply be an alternative means by which a LEC would be compensated for implementing specific resale requests.⁸² The effect would be no different than if a separate charge were established, with the resold service rate being the retail rate less avoided costs.⁸³

⁸¹ AT&T at 83 n.128.

⁸² Alternatively, netting can be viewed as part of the avoided cost calculation. If new service order costs are incurred, then it is inaccurate to assume that all service order costs are avoided. Instead only a portion of the service order costs may be avoided because providing the resold service to a reseller still entails service order activity.

⁸³ AT&T lamely suggests that resale will be affected by disputes over the amount of offsets. Resale will go forward--irrespective of whether there are disputes over avoided costs. The simple fact is that whether or not the specific costs of resale were reflected in a charge, it will not increase or decrease the degree to which resellers will choose to dispute avoided cost calculations. More importantly, state commissions are more than capable of quickly resolving any disputes that arise and meeting their statutory responsibilities. There is no reason for the Commission to interfere with the states in their exercise of the authority that the Act vests in them and certainly AT&T's feckless claim provides no basis for Commission action.

Several commenters argue that there should be no or very narrow resale limitations.⁸⁴ For example, AT&T takes the extreme position that the only resale limitation should be that a reseller could not resell a service at a lifeline rate to a non-eligible subscriber.⁸⁵

The statute recognizes that one form of reasonable limitation would be to preclude a reseller from reselling a service that is only available to one class of customer at retail to a different class of customer. Class of service distinctions are often employed by state commissions to further specific intrastate pricing policies. This Commission would be ill advised to intrude in this sphere of intrastate ratemaking by obstructing a state commission's ability to limit resale by class of service.⁸⁶

Nor should the Commission act to preclude a state from adopting other pro-competitive resale limitations. As BellSouth pointed out in its Comments, the purpose of competition should be for incumbents and new entrants to vigorously compete for customers.⁸⁷ One form such competition takes is promotional offerings. Because the obligation to resell extends to all LECs, failure to exclude such offerings from resale would chill the very type of behavior that the introduction of competition is supposed to create

Another resale limitation that would be a reasonable, pro-competitive restriction would be to preclude the resale of contract service arrangements developed in response to competitive bids. Many states permit LECs to offer a service on a contract basis to a customer where the state

⁸⁴ CompTel at 100, MCI at 84, ALTS at 37-38.

⁸⁵ AT&T at 79-80.

⁸⁶ A state approved resale limitation could be defeated if unbundled elements could be assembled to create the equivalent of a retail service. Such an anomaly provides further evidence that unbundled elements should not be used to create services that are available under the resale provisions of the Act.

⁸⁷ BellSouth at 66.

commission has determined that the service in question is subject to competition. Prohibiting resale in these circumstances would foster true, robust price competition among competitors.

Given that resale restrictions can and do serve procompetitive ends in the local markets, the wisest course is to leave the judgment as to the appropriateness of a resale limitation to the agency that is most familiar with local market conditions--the state commissions. The Commission is in no position to prejudge the state commissions.

E. Interexchange Access

Not surprisingly, IXC's view the Section 251(c) as an opportunity to avoid Commission mandated access charges.⁸⁸ There is nothing in their comments, however, that would support a statutory interpretation that would permit such a result. Indeed, to the contrary, not only is the statute clear that Section 251(c) unbundled elements may not be substituted for exchange access but also any other interpretation would be contrary to the Act's principle purpose of promoting competition in the local market.

As telecommunications carriers, IXC's may seek interconnection and obtain unbundled network elements under Section 251(c), but consistent with the Act, they may do so only for the purpose of "transmission and routing of telephone exchange service and exchange access" that they provide. As IXC's they receive exchange access from LEC's pursuant to tariff. Accordingly, the language of Section 251(c)(2) is clear that IXC's may not use interconnection or unbundled elements to replace the access services (and their corresponding access charges). As the DOJ

⁸⁸ MCI at 72-73, LDDS at 74.

observes, such a statutory construction is consistent with the promotion of competition for telephone exchange service and exchange access.⁸⁹

F. Application of Section 251 to CMRS Providers

Although not widely addressed, there is virtually no disagreement that CMRS providers may fall within the scope of a “requesting telecommunications carrier” for purposes of reciprocal compensation under Section 251(b) (5) provided that the requested interconnection is for the purpose of providing telephone exchange service and exchange access service. If there is any confusion, it would appear to be with regard to the status of CMRS providers under the Act. For example, NWRA attempts to lay out conditions and circumstances where it would view CMRS providers as ILECs.⁹⁰ NWRA, however, misses the point that the statute is clear as to the treatment of CMRS providers. Section 153(26) of the 1996 explicitly states that a commercial mobile service provider is not considered a LEC “except to the extent that the Commission finds that such service should be included in the definition of such term.” Clearly, this provision calls for a future determination by the Commission based on specific facts and circumstances that are then presented and evaluated after adequate opportunity for public comment.

Likewise, CMRS providers are not encompassed by the 1996 Act’s definition of ILEC in Section 251(h)(1). Nor does the Commission need to speculate, as apparently NWRA would have it do, with regard to the criteria to be considered in reclassifying a carrier as an ILEC. Section 251(h)(2) fixes the criteria by which a carrier can be designated as an ILEC. A condition

⁸⁹ DOJ at 42.

⁹⁰ NWRA at 15-16.

May 30, 1996

predicate for the Commission making such a determination is that the carrier be a LEC. As noted above, the condition is not satisfied with regard to CMRS providers.

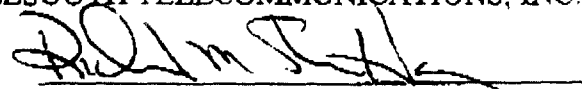
V. CONCLUSION

BellSouth is committed to meeting its obligations under Section 251 and 252 of the Act. Its concern, however, is that under the guise of implementation, the Commission will be drawn in by the comments of some parties and attempt to create a cookbook approach to the provision of interconnection and unbundled network elements with a myriad of details and rigid instructions. Such an approach, which becomes mired in the particulars loses sight of the key, broad foundations of the Act--negotiation, state supervision and competition. For this reason, the Commission must avoid approaching implementation of Sections 251 and 252 in a traditional, regulatory fashion. It must stand back and allow the new regulatory paradigm to operate as Congress intended unencumbered by intrusive federal regulations.

Respectfully Submitted,

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Comments on Hatfield Study

Harry M. Shooshan III
Ross M. Richardson

May 30, 1996

The Cost of Basic Network Elements: Theory, Modeling and Policy Implications prepared for MCI by Hatfield Associates, Inc. ("HA-II") is highly reminiscent of the earlier Hatfield study, *The Cost of Basic Universal Service*, which was released in July 1994 ("HA-I") and it suffers many of the same serious shortcomings we have previously identified.¹ HA-II continues to focus virtually exclusively on the costs of building a local exchange network from scratch and providing basic service. If HA-II's "green field" approach possesses any policy relevance, it may be for a country like Bosnia where telecommunications networks must be built — or rebuilt — from scratch. This approach has little bearing on the real problems confronting regulators in the United States today. As its predecessor, HA-II is merely an effort to make the contribution problem disappear without the need to confront difficult decisions about rate rebalancing, deaveraging and the recovery of relevant overheads and historically incurred burdens.

Our comments focus on two areas: (1) policy relevance; and (2) various conceptual problems and inadequacies. We then turn to the arguments HA-II raises against honoring the historic "regulatory contract."

¹ Calvin S. Monson and Jeffrey H. Rohlfs, *A Bad Policy and an Irrelevant Study: Preliminary Review of the MCI/Hatfield Proposal for Universal Service*, July 27, 1994.

Policy Relevance

It serves little practical purpose to speculate on the theoretical cost of building the United States public switched network from scratch. Building a network from scratch is a luxury few nations can afford. The network we have in place is the world's largest "legacy system"; that is, a mix of hardware and software of many different vintages. It is the result of myriad decisions over time about what types of equipment and technology to deploy, when and where. The public switched network has evolved — warts and all — over several decades.

By way of analogy, note how much easier it would be to set up a new business information system in, say, a Macintosh-based environment than to convert to Macs from an existing IBM-based system environment. There are costs involved in conversion (*e.g.*, reformatting existing files) that would not be incurred were Macs used from day one. The telephone network has, in fact, undergone — and continues to undergo — a series of analogous conversions (from analog to digital, from copper to fiber, from electromechanical to stored program switches). The process is difficult, but it is far less difficult than what HA-II, in essence, proposes, which is simply to chuck it and start over again.

HA-II's view of network design, deployment and operation is perplexing. Network planning is not a static process. Even if we could agree on what is "state-of-the-art" today, that picture would undoubtedly change as time — and the process of actual network deployment — continued. The network we end up with would likely look much different than the original blueprint. Consider the evolution of nontelephone networks, such as those deployed by the cable industry.² Traps have been replaced in many systems by addressable converters. Coaxial cable in the backbone network is being overlaid with fiber. Head-end electronics have changed.

The heart of HA-II's policy prescription rests on the premise that it is beneficial if regulators periodically decide to ignore the realities of this legacy system and evaluate the network "starting from scratch." HA-II suggests a "true up" based on the premise that a pristine network designed primarily to meet today's needs would be constructed differently and cost less than the existing public switched network. Yet this approach is hardly hospitable to network investment. No matter how

² Somehow we doubt that HA would advocate use of their preferred approach to the problem of pricing the network components of monopoly cable systems.

sound an investment might be, *ex ante*, future regulators can always observe, *ex post*, that the investments are inefficient relative to the latest technology.

Unregulated firms are sometimes compelled to write down the value of their assets when conditions change, but regulated firms operate in a different kind of environment. Their prices and investment decisions are regulated by the government and, hence, the administrative contract under which they operate requires that they be offered a reasonable opportunity to recover their investment. If telephone companies are going to be forced to take write-downs as unregulated firms sometimes must, then perhaps they ought also to operate on an unregulated basis. The government has an important stake in permitting regulated firms to recover prudently incurred costs to assure investors that government-approved and government-mandated investments will not be confiscated. If regulated firms are not permitted to recover their investments, the lesson for future investors will be that government cannot be trusted and it will thus become more difficult for government to accomplish its policy objectives.³

MCI wants the prices it pays for access, interconnection and each unbundled network element set using long-run incremental costs with no markups to cover overheads of running the business, shortfalls created by the failure of some prices to recover even their incremental costs, and historical burdens growing out of government decisions to depreciate capital at unrealistically slow rates to keep prices artificially low. HA-II develops a model that attempts to measure the incremental cost of each element or “building block” of their “green field” network. This approach only works if one assumes that there is already an ongoing enterprise and that common and overhead costs are being recovered in the prices charged for other services by the firm. Pricing *all* services at marginal cost is “a recipe for bankruptcy.”⁴ In the incremental, disaggregated “firm” envisioned in HA-II, perhaps there is no Chief Financial Officer with fiduciary responsibility to worry about such things.

³ Professor James Q. Wilson has observed that:
Property and contracts express our society’s commitment to equity as well as to investment.
Government will infringe on property and contracts, sometimes for good reasons and sometimes for bad ones. When it does so on the basis of a promise to allow the cost of that infringement to be recovered, it has an obligation to honor that promise. A healthy economy and a healthy society require that the government keep its word — even to utilities.

“Don’t Short-Circuit Utilities’ Claims,” *The Wall Street Journal* (August 23, 1995, p. A12).

⁴ William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony* (Cambridge, Mass.: The MIT Press, 1994), p. 34.

There is one significant relevant question HA-II fails to address. What should the cost be for each element assuming that you have to build, operate and maintain an entire network? In other words, what does it cost to sustain a viable, functioning firm producing particular sets of outputs?

HA-II offers an easy way out — define the problem as excess investment, imprudently incurred, and compel LEC shareholders to take capital losses. Good public policy entails balancing the equities of all parties. A regulatory contract that is all take and no give may appeal to MCI, but it is manifestly unfair to telephone company shareholders. A government that periodically breaks its promises will find it increasingly difficult to induce firms to do the government's bidding when it comes to deploying the network of the future on a geographically and demographically ubiquitous basis.

Conceptual Problems with the HA-II Approach

There are several serious conceptual problems with the HA-II approach (or lack thereof) to important issues of network design, construction and operation. In detailing these, we have in some cases posed questions about the HA-II model since it is impossible, based on the version filed by MCI, to determine whether or how the model has taken these factors into account:

- How are the costs of technology development and innovation embodied in the model? The HA-II approach assumes a static technology base in an industry where technological change is head-spinning. HA-II takes the benefits of technical progress as given, but ignores the costs entailed in producing it.
- HA-II states: "Rates should be set at economic cost because they are efficient. From a societal point of view . . . [this] will bring the optimal amount of resources into the market" (p. 14). What about the specific identity of the resources deployed? What is the process by which new services and better methods of operating are discovered? HA-II's approach reads like a recipe for manufacturing Soviet swimwear, not deploying a modern telecommunications network. Rates should reflect costs, but costs need to be properly conceptualized to reflect incremental change from an embedded technology base.
- HA-II models a world in which new productive capability appears spontaneously from nowhere. Productive technology and new plant capacity must come from "inventory" and "inventory" is built up over many years of design/construction/provisioning activity. The risks and opportunity costs of the resources needed to develop such "inventory" have to be recognized on the books.

- HA-II notes that the “green field” model “is not constrained by the existing network topography [sic]” (p. 16). HA-II thus assumes that the LECs can instantaneously and without friction or cost relocate their end offices and access tandems to wherever makes economic sense. The IXCs would presumably be very unhappy with this result. They have built their businesses around existing LEC network topologies and they would perhaps be even more reluctant to rearrange their networks than even the LECs. The Bell Companies were obligated under the MFJ to meet the IXCs at “a point . . . within an exchange area designated by an interexchange carrier” (Decree at IV F). Any “inefficiencies” in network topology are thus ironically, in some degree, due to demands by MCI. More generally, such legal and regulatory requirements were/are just as real as the “economic” requirements that HA-II dismisses as “excessive overhead.”
- There would be huge costs associated with flash-cutting to a new generationally homogeneous “green field” network. Those costs are not reflected in HA-II’s model. Indeed, the complex activity associated with updating the network to the “best available technology” is usually called “planning,” an activity which, interestingly enough, HA-II dismisses as “excess overhead” (pp. 30 and 35) and apparently unloads in Table 5.
- Population growth everywhere is assumed to be 4.3 percent, but the North American Numbering Plan is not being exhausted by population growth, rather by growth in devices (and software processes) needing network terminations. Given the explosive growth in mobile telephony, business voice, fax and data, and in light of the long lead-times needed to pull fiber, it is entirely possible that the LECs are actually *behind* the curve rather than ahead of it as conjectured.
- HA-II states: “In actuality LECs will deploy . . . to take advantage of population variations” (p. 29). However, because network planning and deployment take a substantial amount of time, LECs must also deploy *in anticipation of* changes in population. They run the risk of being wrong, or of starting out right only to have events beyond their control change the outcome (*e.g.*, people leaving urban core areas for socio-economic reasons). LECs also deploy based on regulatory obligations and expectations. These effects are not modeled
- Where are real estate costs embodied in the model? For example, when HA-II rehomes the network using existing end-office locations (p. 32), what assumptions do they make about the price of real estate in midtown Manhattan? What about acquisition and construction costs for right-of-way and conduit?
- How does HA-II price out switches? This is particularly important when comparing the “green field” to the real world where, once a LEC buys a switch, it is locked in in terms of software upgrades. Vendors (such as AT&T, now Lucent) have been known to attempt to exploit their market power in the aftermarket.

- HA-II asserts that LECs' historical overheads "seem excessive when compared to firms that operate in a competitive environment" (p. 30). Of course, the LECs incur costs not incurred by firms in competitive markets precisely because of the regulatory and legal obligations that are unique to the industry. What expenses result from these obligations? HA-II ignores the active role state regulators typically play in evaluating the prudence of LEC investments.
- HA-II states: "The depreciation reserve deficiency is a relatively small portion of total LEC plant in service" (p. 38). That is true only if you use the depreciation rates ordered by the regulators. The old depreciation reserve deficiency was an accounting statement that showed that plant was significantly underdepreciated by the regulator's own standards! While that problem has been reduced, there remains the question of whether the depreciation schedules set by the regulators match the loss of economic value actually occurring in the industry. HA-II fails to address this concern, but remarks that the decline in economic value of LEC plant far exceeds regulatory depreciation.
- HA-II implies that much of alleged excess investment (*viz.*, fiber deployment) is in anticipation of the Bell Companies entering new lines of business (*e.g.*, the interLATA market). Yet, HA-II makes no finding that fiber deployments are consistent with any such plan. Are they?

These conceptual shortcomings and unanswered questions suggest that the HA-II model cannot form a sound basis for important public policy decisions by regulators.

Abandoning the Regulatory Contract

HA-II offers a number of reasons why regulators should abandon the "regulatory contract":

HA-II: The LECs will be made whole by the additional demand stimulated by lower prices.

Comment: If all its prices are set at incremental cost, the firm will go bankrupt. Stimulating demand in this fashion will only speed its demise.

HA-II: The LECs are not guaranteed recovery of excess costs.

Comment: The real issue is not excess costs, but the costs that have been incurred under regulation. Regulators have a stake in allowing regulated firms to recover the costs those firms incur under — and because of — regulation in order to insure future investment. Otherwise, the credibility of the regulators will be undermined.

HA-II: The LECs were more than made whole by the “giveaway of cellular licenses” in the 1980s.

Comment: This is like saying, “It’s okay if the tree I’m cutting down falls and destroys your house, because I helped you build your deck last summer.”

HA-II: In competitive industries, shareholders bear the burden of uneconomic expenditures.

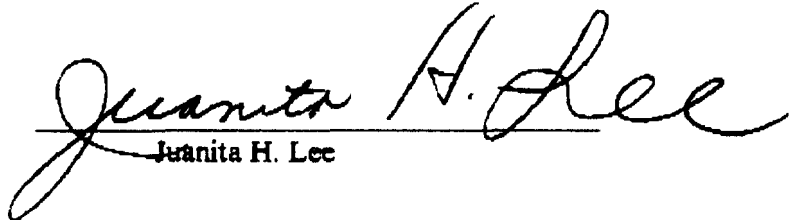
Comment: Of course, that is *unregulated*, competitive industries. In a regulated industry, shareholders rely on regulators to keep their promises. HA-II does not propose to “flash cut” regulation of the LECs, the logical corollary of their “break-the-contract” approach.

HA-II: Competition will develop slowly, so there’s no immediate crisis for the LECs.

Comment: Whether death results from a sudden heart attack or a long, debilitating disease, in the end, you are dead. The pricing approach HA-II recommends will harm the LECs and their shareholders and intensify the current cost-recovery problem. What is needed is a comprehensive approach to policymaking that simultaneously addresses the whole panoply of interrelated problems posed by efficient transition to competitive local markets.

CERTIFICATE OF SERVICE

I hereby certify that I have this 30th day of May, 1996 served all parties to this proceeding with a copy of the foregoing **REPLY COMMENTS** by placing a true and correct copy of the same in the United States Mail, postage prepaid.



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